FRBSF Weekly Letter

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The U.S. Economy and Monetary Policy

In recent months, domestic and international financial markets have experienced sharp swings. Not only has actual inflation picked up, but more importantly, inflationary expectations appear to have increased as well. The yield on 30-year Treasury bonds has risen about 1 percentage point since late March, and mortgage rates have increased even more. Moreover, bond yields have fluctuated widely from day to day. The stock market also has been highly volatile, with the Dow Jones industrial average registering changes of more than 50 points in the period of a day on seven different occasions in April and May!

Meanwhile, the dollar has depreciated, on balance, and there has been an unusually close day-to-day relation between changes in the dollar/yen exchange rate and in U.S. bond yields. Finally, amid these developments, the Federal Reserve took the unusual step on April 30th of publicly announcing that it had tightened monetary policy; West Germany and Japan then followed by easing their policies.

In this *Letter,* these events are put into the broader perspective of longer run trends in the economy; also, their implications for the economy's outlook over the next year-and-a-half and for Federal Reserve policy are discussed.

Setting the stage

The U.S. economy is in its fifth year of economic expansion. Since the end of 1982, 12 million jobs have been added to civilian employment, and the unemployment rate has fallen from almost 11 percent to less than 6½ percent. Even more notable, these gains have been accompanied by significant reductions in inflation and interest rates. Measured by the broad-based GNP price index, the inflation rate dropped from almost ten percent in 1981 to 2½ percent last year, while the yield on 30-year Treasury bonds declined from nearly 15 percent in late 1981 to less than 7½ percent earlier this year. These are impressive accomplishments about which we can be justifiably pleased.

These gains, however, mask serious imbalances in our economy, namely, the huge deficits in our federal budget and in our trade with other nations. In fiscal year 1986, the federal deficit reached $221 billion, up from $79 billion in 1981. Our international balance of trade in goods and services moved from a small surplus in 1981 to a deficit of just over $140 billion last year.

The two deficits are closely related. The trade deficit reflects national spending beyond what the nation produces. The most notable example of this excess spending is the steep increase in the federal budget deficit from 2.7 percent of our national output in 1981 to 5.3 percent last year. Moreover, the consumer sector has added to the imbalance by increasing its spending faster than its income; between 1981 and 1986, personal saving declined from 7½ percent to under 4 percent of after-tax household income. This excessive national spending has been made possible by huge capital inflows from abroad, which are the counterpart of the foreign trade deficit.

Clearly, this is an unsustainable situation. No nation can live beyond its means indefinitely by drawing down its investments abroad and by borrowing from other countries. Moreover, as one of the wealthiest nations in the world, we should be exporting our savings to less developed countries, not *importing* the savings of others to finance excessive private and public consumption. Sooner or later, we will have to generate a trade surplus to service our foreign debts. And the sooner we can begin this process by reducing our excessive domestic spending, the less painful the necessary adjustment in the future will be.

The trade imbalance has caused serious dislocations in many of our industries. From 1981 to 1986, our exports fell five percent in real, or inflation-adjusted, terms while real imports rose more than 50 percent. Agriculture, mining, and some types of manufacturing have been adversely affected by foreign competition, causing dislocations that have hit some regions particularly hard.

A tide of protectionism has risen in response to these developments, and it threatens the health of the world economy. Trade barriers invite retaliation, raise prices, reduce the volume of trade worldwide, and lower living standards both here and abroad. They are particularly harmful to less developed countries, many of which depend on earnings from exports to pay back and to service huge foreign debts.

Economic outlook
This year and next, reasonably good economic growth is expected and is likely to be accompanied by some improvement in the major imbalances that have plagued the U.S. economy.

The main engine of growth will be an improvement in our trade balance, in response to the depreciation of the dollar since February 1985. Research at the San Francisco Reserve Bank predicts that the deficit of real imports over exports of goods and services will be cut from just under $150 billion in the fourth quarter of last year to less than half of that amount by the end of next year. The significant improvements in our trading position over the last couple of quarters support this expectation. Such progress is crucial as it would give the economy a lift and help stem the dangerous protectionist sentiment in the Congress and around the world.

Growth in government spending can be expected to be relatively weak this year and next. The Gramm-Rudman targets for deficit reduction probably will not be met, but there still should be decreases in the deficit of about $50 billion in fiscal year 1987 and about $15 billion in 1988.

Such reductions most likely will be a restraining factor on economic growth in the years immediately ahead, but smaller federal deficits are essential for the overall health of the U.S. economy. Without a budget deficit reduction, it is difficult to imagine how we could significantly reduce our trade deficit without creating more problems in our domestic economy. As our foreign trade deficit narrows in response to a weaker dollar, we shall be receiving less savings from abroad. If the government's need for savings to finance its deficit spending were not reduced commensurately, interest rates in this country most likely would rise and hamper the performance of the domestic economy.

Household spending on consumption goods, especially durables, is generally expected to be sluggish this year. In part, this sluggishness reflects dissipation of last year's boosts to consumer spending provided by declining interest rates and oil prices. This year, households are likely to want to restore their saving to a more normal relation to their incomes.

In the short run, higher saving rates will tend to depress consumer goods industries, just as efforts to bring down the federal deficit will hurt government contractors and employees. But, in the long run, the nation needs to cut back on consumption both to release funds for servicing our overseas debts and to add to the domestic capital formation that is the basis for future economic growth.

Both residential and nonresidential investment also are likely to be sluggish this year and next. Recent increases in long-term interest rates are likely to restrain both kinds of spending. In addition, several elements of the tax reform legislation that went into effect this year — the elimination of the investment tax credit and of certain tax shelters, as well as the lengthening of service lives for depreciation purposes — are putting more downward pressure on investment in business equipment and construction. Finally, high office and industrial vacancy rates do not bode well for those types of construction.

Business investment in inventories is likely to make a significant positive contribution to the average pace of economic growth this year, but most of this boost may already have passed. A large part of the rapid 4.4 percent increase in the economy's output of goods and services in this year's first quarter went into inventories (especially of autos). Since inventory investment should drop off to more normal levels in the remainder of the year, output growth is unlikely to maintain the rapid first quarter rate.

Taking all of these prospective developments into account, the total output of the economy is expected to grow by about 3 percent in 1987 and 2½ percent in 1988. Some consider growth in this range to be "sluggish," but given the likely rate of increase in our nation's labor force and its productivity, the long-run potential growth rate that our economy can sustain appears to be around 2½ percent. Moreover, by most estimates, the current 6.3 percent unemployment rate is close to "full" employment for the U.S. economy. Thus, faster growth this year and next could move the economy dangerously close to capacity constraints, at least in terms of labor, and in that circumstance, could bring us face to face with a serious inflation problem again.

Inflation outlook

Even if output were to grow at the moderate pace described, the inflation rate, as measured by the broad-based GNP Price index, would likely average around four percent this year and next — significantly above the 2½ percent rate recorded last year. The beneficial effect of the sharp drop in the price of oil early last year, which held inflation down, has now passed; oil prices, in fact, have been climbing since the middle of last year.

Prices in the U.S. also are being pushed up by the depreciation of the dollar, which is raising the cost of imported goods and services. In the first quarter, the average prices of our imports rose at an annual rate of 14 percent. This pattern is likely to continue as the effects of the dollar's depreciation over the last two years work themselves through the economy. Unfortunately, the inflationary effects of the dollar's depreciation are a necessary part of the mechanism by which the trade deficit is brought down.

Recent increases in medium- to long-term bond yields seem to reflect the prospect of more inflation as investors require higher returns to offset the expected decline in the purchasing power of those returns. In the last couple of months, there has been a close day-to-day relation between changes in the value of the dollar (especially against the Japanese yen) and changes in U.S. bond yields. On balance, the increase in bond yields has been associated with a depreciation of the dollar. This pattern suggests that the bond markets recognize that exchange rate movements will influence the inflation rate for several years. But it also may reflect concern about whether the Federal Reserve has the resolve to prevent a more persistent inflation problem from developing.

Although a higher inflation rate is expected this year and next, it need not be the beginning of an upward spiral of prices. Once the dollar has stabilized, the upward pressure on import prices, and hence on domestic inflation, should gradually subside. However, there is a danger that temporary increases in inflation will become embedded into inflation expectations, and, in turn, into longer term wage and price contracts. Such an occurrence would mean a more persistent inflation problem, and its possibility places an especially heavy burden on the Federal Reserve to choose an appropriate monetary policy.

Monetary policy

In designing monetary policy, the Federal Reserve often must balance the demands of competing goals. As always, we recognize the need to promote the continuation of the current economic expansion. This year, there is also good reason to emphasize concern about a threat of renewed inflation.

With rising import costs tending to push up the average level of prices and the economy near full employment, it is especially important that the Federal Reserve avoid policies that might make the economy expand too rapidly. If the effects of the increase in import prices were to be reinforced by strong domestic demand for goods and services, higher import prices would be more likely to spill over into persistent domestic wage and price inflation.

To avoid this problem, it is essential that the Federal Reserve be cautious in its provision of liquidity to the economy. Our decision in February to reduce the 1987 target ranges for growth in the monetary aggregates, M2 and M3, by ½ percent to 5½ to 8½ percent, was a signal of our resolve to continue controlling inflation.

The tightening of policy announced by Chairman Volcker on April 30 also is in line with these concerns about inflation. As discussed, the decline in the dollar since early 1985 can be expected to add significantly to both inflation and economic growth this year and next. If the dollar were to fall sharply from present levels, inflation could rise considerably above the projected 4 percent rate, while a more rapid improvement in the trade deficit could cause the economy to "overheat." The recent tightening of monetary policy in the U.S., in combination with reductions in interest rates in Japan and West Germany, should cushion the decline of the dollar, and thus temper potential excessive pressures on economic growth and inflation.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/3/87	Change from 5/27/87	Change from 6/4/86 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	206,480	648	3,412	1.6
Loans and Leases[1] [6]	183,171	602	- 1,141	- 0.6
Commercial and Industrial	53,485	- 85	343	0.6
Real estate	68,491	131	1,970	2.9
Loans to Individuals	37,149	- 166	- 3,720	- 9.1
Leases	5,386	0	- 236	- 4.1
U.S. Treasury and Agency Securities[2]	16,049	90	5,110	46.7
Other Securities[2]	7,261	- 42	- 557	- 7.1
Total Deposits	209,935	3,505	1,287	0.6
Demand Deposits	55,021	1,660	713	1.3
Demand Deposits Adjusted[3]	37,051	949	619	1.6
Other Transaction Balances[4]	20,052	878	3,380	20.2
Total Non-Transaction Balances[6]	134,862	968	- 2,806	- 2.0
Money Market Deposit Accounts—Total	45,062	339	- 1,745	- 3.7
Time Deposits in Amounts of $100,000 or more	32,186	355	- 4,370	- 11.9
Other Liabilities for Borrowed Money[5]	25,147	- 747	1,972	8.5

Two Week Averages of Daily Figures	Period ended 6/1/87	Period ended 5/18/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	56	81
Borrowings	52	43
Net free reserves (+)/Net borrowed(−)	4	38

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change